

TESTIMONY OF
Henry J. Aaron¹

TO THE
COMMITTEE ON FINANCIAL SERVICES
THE HOUSE OF REPRESENTATIVES
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Mr. Chairman:

Thank you for inviting me to testify on current monetary and fiscal policy. In my remarks I shall make five major points:

- h Budget deficits for the next decade are likely even if the president's tax cut plan is not adopted. They are likely to be huge if it is adopted. The actual situation is worse than official projections indicate because they are based on demonstrably unreasonable assumptions.
- h The longer term budget situation is more dire still, principally because of projected increases in the cost of Medicare and Medicaid and to a smaller degree because of growth in Social Security outlays.
- h In the face of such projections, acceleration of tax cuts enacted in 2001 and the passage of still other tax cuts would be rash and unwise. All currently-scheduled, but not-yet-implemented, tax cuts should be put on hold, and consideration of all additional tax cuts should be shelved until the medium-term and long-term budget problems have been resolved.
- h Current possible economic weakness *may* justify short-term economic fiscal stimulus, although the need for it remains dubious. But any such stimulus should "sunset" quickly, certainly before the end of calendar year 2004 so that it minimally aggravates the already serious long-term budget problem.
- h The so-called "Jobs and Growth" program will promote neither job creation nor economic growth over the long-term. Both the administration's own economic analyses and that of the Congressional Budget Office support this statement.

¹ Bruce and Virginia MacLaury Senior Fellow, The Brookings Institution. The views expressed here are my own and do not necessarily reflect those of the staff, officers or trustees of the Brookings Institution.

THE TEN-YEAR OUTLOOK

As budget prospects have deteriorated, some officials and analysts have taken to bad-mouthing the ten-year projections that the Congressional Budget Office routinely makes. The projections, they say, are unreliable. Even if the projections are reasonable, the deficits, they say, are not very large. And even if deficits are sizeable, they say that they are relatively unimportant because other things matter more. The first reason for dismissing budget projections is right but irrelevant. The second is wrong because the official projections are unduly rosy. The third is correct, but also irrelevant.

The charge of unreliability is doubtlessly correct. The Congressional Budget Office, which produces the most widely cited projections, devoted a whole chapter in their report on *The Budget and Economic Outlook* this year to the problem of uncertainty. CBO also annually publishes something called the “fan chart” which shows the range of future possible budget balances based on their current best guess modified by the historical record of how far off their best guesses have been. Ten years out they say that the actual budget balance could fall outside a range stretching from \$500 billion higher to \$500 billion lower than their projection with a likelihood of about one chance in twenty. Before CBO prepared the fan chart, many of us were fond of using a chart originated by former CBO director Robert Reischauer which showed that projected deficits just five years out changed by as much as \$400 billion over periods as short as three years.

But the unreliability of projections, while a fact of life, does not excuse us from making them or heeding them. Laws change. Economic surprises occur. Analytic techniques improve. But just because I am uncertain about what lies over the crest of the hill does not make it prudent for me to drive on the wrong side of the road. And that is just what fiscal policy is doing right now. Current official projections indicate that the budget (excluding reserves being accumulated to pay for future pension and health benefits) will be in deficit by \$1.8 trillion over the period 2004 to 2008 and by and by \$2.5 trillion over the period 2004-2013.

These projected deficits are unrealistically low.

- They exclude the first supplemental for the Iraqi war (and, of course, any additional ones).
- They exclude the revenue loss that will be necessary to keep millions of people from sinking into the morass of the alternative minimum income tax.
- They exclude the revenue loss to prevent the 2001 tax cuts and other repeatedly renewed provisions from expiring.
- And they exclude the cost of added expenditures that may result if Congress increases domestic discretionary at all in real terms.

A policy of balancing the budget exclusive of additions to pension health reserves would, in my view, be prudent. It may be so far beyond the reach of current policy that some members of Congress would rather not even talk about it. But that is the sort of planning all of us would expect from prudent businesses. In my view, we should demand no less for our nation.

Failure to pursue such a policy has very large costs. Compared to a policy of balancing the budget exclusive of additions to pension and health reserves, actual policy is likely to deprive the nation of approximately \$5 trillion in domestically owned capital by 2013. The steady short fall in the accumulation of domestically owned capital will result in a cumulative loss of national output of roughly \$1.5 trillion over the decade from 2004-2013 and of \$300 billion in 2013 alone.

Can you or I be sure of these projections? Of course not! Would such uncertainty give you license to pursue deficit increasing policies? Does the question require an answer?

THINGS GET WORSE

Things get worse after the current budget window because retiring baby-boomers and increasing *per capita* medical costs are projected to push up federal spending on Social Security, Medicare, and Medicaid. The first baby-boomers become eligible for Social Security in 2008 and for Medicare in 2011. Between now and 2008, the share of GDP devoted to these two programs and Medicaid is not projected to change and it is projected to rise by just one percentage point by 2013. Costs rise steeply thereafter. The Congressional Budget Office anticipates that the share of GDP devoted to these three programs alone will rise by 7.9 percentage points between 2000 and 2040.

Costs rise for two reasons. Everyone knows the first—the baby-boomers will be retiring. The second factor, nearly as important as the first, is that age-adjusted health care costs are projected to rise sharply.

The cost of Social Security, measured as a share of GDP, is projected to rise by 2 percent of GDP over the four decades from 2000 to 2040. That increase is the same as the actual increase in Social Security costs that occurred between 1970 and 1983. Nobody paid much attention to that increase. The economy took it easily in stride. If nothing other than the projected increase in pension costs were happening, I believe that the economy would also take in stride the future increase in Social Security costs, which is spread over forty years not just thirteen.

One reason the cost increase is so modest is that in 1983 Congress enacted benefit cuts of about 15 percent that are being phased in gradually and will partly offset the added pension costs for the boomers. These benefit cuts are mislabeled and misunderstood as an “increase in the retirement age.” In fact, the Social Security entitlement age was, is, and—under current law—will remain age 62. The effect of increasing the “full benefits age” is simply to cut benefits relative to prior law, whenever people elect to retire after age 62.

But much more is projected to happen. Three quarters of the increases in costs for benefits for the elderly and disabled are projected to occur in the health programs, Medicare and Medicaid. The driving force behind the projected increase in the cost of these programs is not simply a jump in the number of beneficiaries, nor is it a projected increase in the average age of beneficiaries. If the number of beneficiaries were all that is involved and health costs rose no more than earnings do, then Medicare and Medicaid costs would increase roughly half as much as the projections indicate. Nor are costs rising because the average age and, hence, the average health care cost of Medicare and Medicaid beneficiaries is projected to increase between now and 2040. It isn't. Because of the rapid addition to beneficiary ranks of newly eligible and therefore relatively young boomers, the age distribution of Medicare and Medicaid beneficiaries will not change much until after 2040.

Medicare and Medicaid costs are projected to rise fast also because the menu of health care services is expected to lengthen and the age-adjusted cost of those services is projected to increase. Were it not for this projected increase in costs, projected Medicare and Medicaid costs would rise roughly half as fast as projected.

Regardless of the source, the bottom line is that the major threats to the budget lie outside the ten year budget window on which most attention is now focused. To formulate current budget policy without regard for what occurs just beyond it is foolish.

NO NEW TAX CUTS!

The foregoing fiscal picture—current, medium term, and long term—is uniformly bleak. However bleak, these projections make no allowance for fiscal damage from future recessions. They make no allowance for future wars or other foreign policy threats that may necessitate increased defense or overseas spending. In brief, under current policy the U.S. government is not paying for the services Congress has voted. How future Congresses may deal with this gross fiscal imbalance remains unclear. But one thing is clear—any further tax cuts now—any at all—will exacerbate those problems.

President Bush and his supporters have argued that tax cuts he has proposed will not have these bad effects. Unfortunately, they have presented no credible evidence to support this claim. The laws of arithmetic decree that the direct effect of tax cuts is to lower revenue. Only if the tax cuts stimulate income growth so much that taxes on that added income exceed the initial reduction could a tax cut lower the deficit. No responsible forecaster thinks that is likely. Here is why.

Even without additional tax cuts, most forecasters expect that the combination of stimulative monetary and fiscal policies over the last two years will return the economy to full employment soon. The speedy victory in the war in Iraq makes that forecast more likely. The threat of SARS makes it less likely. But when the economy does return to full employment, a tax cut can increase revenue only by raising growth. The direct effect of tax cuts that permanently lower revenue in an economy with fully employed resources is just the reverse—to cut revenues, increase the deficit, and lower

national saving. Well-designed tax cuts also stimulate labor supply and private saving, which positively affect growth. But even with well-designed tax cuts, the balance of reduced public saving, increased private saving, and increased labor supply is as likely to lower growth as to increase it and is most unlikely to raise revenue.

President Bush's proposed tax cuts were not well designed to promote growth. All of the initial benefits from the dividend exclusion would apply to profits generated by capital already in existence, which, by definition, is immune to any positive tax incentives. A tax cut well-designed to stimulate investment would apply entirely or principally to new investment. The tax exclusions for personal saving would do more to facilitate asset transfers from existing taxable accounts—which lowers growth by cutting revenues, increases the deficit, and lowers national saving—than to encourage additional saving—which adds to income growth. And the increased child credit, which has appealing distributional features, would lower labor supply, not increase it. Labeling such a plan a Jobs and Growth plan owes more to rhetorical creativity than to descriptive accuracy.

This is the clear verdict on President Bush's proposed tax cuts from the honest trial of dynamic scoring reported recently by the Congressional Budget Office.² CBO ran several models that allow for feedbacks of tax changes on growth. Some models predicted the plan would lower growth, others that it would increase growth. All predicted that it would increase the deficit. This CBO report flatly refutes any claim that tax cuts will raise revenue by spurring growth and shows that effects on growth are as likely to be negative as positive.

The economic model that the Administration cited in support of its economic program also casts doubt on the long-term value of that program.³ This model forecasts higher employment and income this year and next if the monetary authority allows the money supply to grow as fast with the tax cut as they would without it. This assumption is almost certainly unrealistic as most observers think the FED is likely to use economic recovery as an opportunity to boost interest rates so that it will have room to cut them in the future if economic weakness reappears. But even if the assumption regarding monetary policy turns out to be correct, the same model indicates that the administration's program will reduce economic growth after 2004 for the rest of this decade and boost unemployment from 2006 through 2014.

I realize that neither a Congressional majority nor the administration is disposed now to reconsider the 2001 tax cuts. This unwillingness is unfortunate. When the 2001 tax cut was enacted, the United States was basking in what turned out to be the Indian summer of the longest economic expansion in U.S. economic history. Al Qaeda had not yet violated the nation's domestic

² Congressional Budget Office, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2004*, March 2003, pp. 16-32.

³ Macroeconomic Advisers, LLC, *A Preliminary Analysis of the President's Jobs and Growth Proposals*, January 10, 2003

tranquility. Budget projections were as rosy as they have ever been. If events since then have not been sufficient to cause a reconsideration of the size or duration of that tax cut, one struggles to imagine what cataclysm would be great enough to do so.

At a minimum, however, the deplorable state of the federal budget and the likelihood that the situation will grow more dire should cause Congress to reject any additional permanent tax cut at this time. The word "any" includes not only a tax cut of the magnitude proposed by President Bush in January, but also the so-called compromise cuts of only \$550 billion or \$350 billion over ten years, particularly if the plans are back-loaded so that the revenue loss grows.